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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.

DOCKET NO. G-04204A-06-0463

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR.

DOCKET NO. G-04204A-06-0013

IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.

DOCKET NO. G-04204A-05-0831

UNS GAS' EXCEPTIONS

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UNS Gas, Inc. ("UNS Gas" or the "Company"), through undersigned counsel, hereby respectfully submits its exceptions to the Recommended Opinion and Order ("ROO") issued by the Presiding Administrative Law Judge in this case.

The ROO fails to provide UNS Gas with a reasonable opportunity to recover its costs of providing utility service and earn a reasonable return on its investment devoted to public service. While there was no finding that any UNS Gas cost or investment was imprudent, the ROO eroded the Company's rate request by, among other things:

(i) failing to include Construction Work in Progress ("CWIP") in rate base;

(ii) precluding the Company from recovering the cost of the Commission-required Global Information System ("GIS");

(iii) establishing an artificially low return on equity;

(iv) setting the monthly charge too low;

(v) disallowing prudently incurred expenses; and

(v) rejecting fair value as the basis for setting rates.[1]

If the Commission were to adopt the ROO in its current form, UNS Gas would realize an earned return on equity of approximately 7%. Moreover, UNS Gas' financial metrics would fall far below other similar gas utilities. For example, UNS Gas' Funds from Operations ("FFO") interest coverage and its FFO to debt ratio will be far below industry averages. Likewise, UNS Gas' net cash flow as a percentage of capital expenditures will be far below the industry average. In 2008, UNS Gas' net cash flow will be only about half of the required capital expenditures. Thus, UNS Gas will have to seek substantial amounts of new capital. If the ROO is adopted, new debt and equity capital will become ever more expensive because UNS Gas is riskier than other gas companies. In the long term, the combination of a substantial need for new capital and

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[1] The ROO also modified various other components of the Company's rate request. These adjustments are discussed in detail in UNS Gas' post-hearing briefs, which by this reference are incorporated herein. UNS Gas does not waive any of the positions or requests that it has presented in this case.

increased capital costs is a poor recipe for both ratepayers and shareholders. Urgent action is needed now to avoid these consequences and to put UNS Gas on firm financial footing.

If the ROO is not amended, the Company will have no option but to file another rate case as soon as possible to recover those prudently incurred costs and investments that, simply for timing reasons, are being ignored in this case. As UNS Gas' Chief Executive Officer, Mr. James S. Pignatelli stated:

> We do believe, though, that what we have requested here is the bare bones rate increase. It's what we need to continue to have a viable entity charged with providing safe and reliable service.
>
> . . .
>
> We don't want to come in next year and the year after and the year after and start a never-ending parade of rate proceedings. That's why we must look beyond what technically maybe a historical test year is and get to the broader picture. What does it cost to serve the customer in the manner in which this Commission and this company desire to serve the customer?
>
> I can tell you we have over $85 million invested in equity in these properties. We have not taken a cent out of these properties. We continue to put additional money into these properties. We're incurring significant growth. We're up to almost 150,000 customers now, and this customer growth continues at an annual rate of 5 to 10 percent. We are serving gas in over half the state of Arizona, the sparsely populated half and the half that is growing rapidly.
>
> . . .
>
> We have to work together to come to the right conclusion. I believe that we have done a fine job in maintaining a high level of service while our costs have skyrocketed. We held out rate relief for three years. Current rates reflect 2001, at best, costs. We need relief.[2]

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[2] Hearing Transcript ("Tr.") at 52-55.

No one can seriously argue that it would be in the public interest to subject the Company, its customers or the Commission to a series of rate cases that can reasonably be resolved in one proceeding. Nevertheless, that is the very process that the ROO will force the Company to follow.

UNS Gas respectfully requests that the Commission amend the ROO in accordance with these exceptions and issue a final order in this case that will allow the Company to timely recover its prudently incurred costs and provide it with an opportunity to earn a reasonable return on its prudent investment. UNS Gas needs adequate rate relief in order to continue to provide safe and reliable gas service to its current and future customers. In support hereof, UNS Gas states as follows:

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I. THE EVIDENCE IN THIS CASE SUPPORTS THE INCLUSION OF CWIP IN RATE BASE.

UNS Gas has requested that $ 7.2 million of CWIP be included in rate base in this case for ratemaking purposes. The ROO rejects the Company's request in its entirety and precludes CWIP from rate base. The requested CWIP must be in rate base in order for just and reasonable rates to be set for the Company at this time.

A. The Commission should approve CWIP in this case.

CWIP is an accepted regulatory tool that has been used by many states including Arizona for many years.[3] The ROO states that CWIP should be put in rate base only when there is an "extraordinary situation" and a "cash-flow crisis".[4]

The Arizona Supreme Court, on the other hand, has explicitly endorsed the use of CWIP, stating that "we wish to make it clear that construction work in progress ("CWIP") but not yet in service may be included in determining a fair value rate base."[5] The court said that it "is obvious that the Commission can consider matters subsequent to the historic year. Construction projects

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[3] Ex. UNSG-28 at 7.

[4] ROO at 6-7.

[5] *Arizona Community Action Assoc. v. Arizona Corp. Comm'n*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979)(quoting *Arizona Corp. Comm'n v. Arizona Public Service Co.*, 113 Ariz. 368, 371, 555 P2d 326, 329 (1976).

contracted for and commenced during the historical year may certainly be considered by the Commission."[6] CWIP is a means of allowing the utility and customers some time between rate cases. The court approved of that effect, commenting that "a constant series of extended rate hearings are not necessary to protect the public interest."[7]

In fact, CWIP is an important tool for dealing with the impacts of growth. UNS Gas faces extraordinary growth. The new plant investment necessary to serve this growth depresses UNS Gas' cash flow and other key financial measurements. Allowing CWIP will reduce those problems. In the long term, neither ratepayers nor shareholders benefit from a financially weak utility. Over the long term CWIP lowers the cost of debt and equity and reduces revenue requirement.[8] Moreover, the inclusion of CWIP in rate base produces significantly lower equity costs for a public utility and the savings in equity costs imply correspondingly lower ratepayer burdens.[9] The Commission should approve CWIP to help restore UNS Gas' financial health, and to give customers and UNS Gas some breathing room between rate cases.

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B. UNS Gas faces extraordinary growth, which, without the inclusion of CWIP, will result in severe financial stress.

It is undisputed that UNS Gas has faced, and will continue to face, high levels of growth.[10] For example, from 2003 to 2006, UNS Gas experienced a 35.4% increase in net plant investment, and the forecast for 2006 to 2009 is 36.9%.[11] On a per-customer basis, this investment level has increased by 19.1% over the period 2003 to 2006, and is forecasted to grow by 19.3% for 2006 to 2009. By any measure, these are extraordinarily high rates of growth. UNS Gas' growth rate is

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[6] *Id.*

[7] *Id.,* 123 Ariz. at 230-31, 599 P2d. at 186-87.

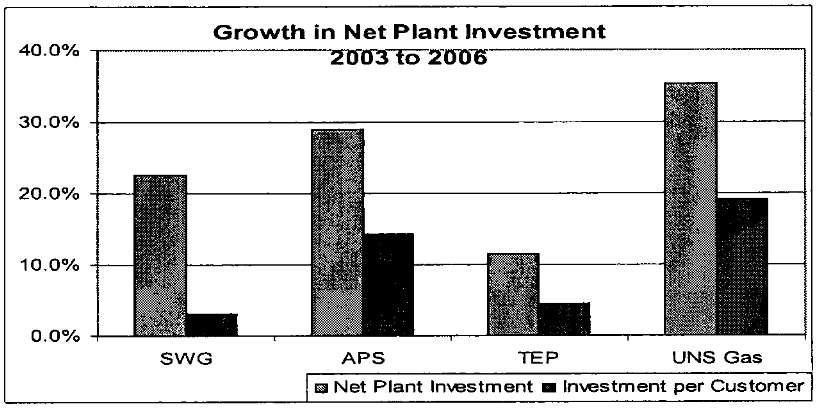
[8] *See* James C. Bonbright et al, *Principles of Public Utility Rates* (2nd ed. 1988) at 251 citing Roger A. Morin "An Empirical Study of the Effect of CWIP on Cost of Capital and Revenue Requirements" *Public Utilities Fortnightly* July 10, 1986 (Part I) and July 24, 1986 (Part II).

[9] Roger A. Morin, *New Regulatory Finance* (2006) at 367-69.

[10] Ex. UNSG-29 at Ex. KCG-15; Tr. at 920, 1004-5, 1020.

[11] Id.

much higher than other Arizona utilities. For example, a comparison in the growth of net plant investment for major Arizona utilities is shown in the graph below:



As may be seen from this graph, the recent growth in net plant investment on a per-customer basis is approximately six times higher than that experienced by another gas utility in Arizona, Southwest Gas Corporation ("Southwest Gas"). This extraordinary growth rate is due in large part to the low embedded cost of plant at UNS Gas, so rate base per customer is much higher for new customers than for existing customers.[12] For this reason, extra revenue from new customers is not sufficient to cover the capital costs required to serve them. Therefore, UNS Gas will likely be unable to earn its authorized rate of return in the foreseeable future.[13] Yet, UNS Gas faces very high capital expenditure requirements.[14] It is essential that UNS Gas maintain an ability to attract capital to meet these capital expenditure requirements. Even if the Commission grants all of UNS Gas' requests in this case, UNS Gas will need to attract tens of millions of dollars in new capital in the next few years.[15]

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[12] Ex. UNSG-28 at 8; Tr. at 956.

[13] Ex. UNSG-28 at 8.

[14] Id.

[15] See, e.g., Ex. UNSG-27 at 27 ($43 million in additional capitalization through 2009); Ex. UNSG-15 at 4 (noting more than $61 million in capital spending from 2001 to 2005).

C. If CWIP is not allowed, UNS Gas' financial integrity and ability to attract capital will be impaired.

The rates proposed by the ROO are woefully inadequate. The ROO's proposed rates do not allow UNS Gas even a reasonable opportunity to earn the low ROE proposed in the ROO. Indeed, the ROO's proposed rates would result in an earned ROE of approximately 7% for the next several years.[16] This is far below the 10% ROE proposed by the ROO. Thus, even if 10% were a reasonable ROE, UNS Gas simply will not have a reasonable opportunity to earn that return.

Under the ROO's proposed rates, UNS Gas's financial metrics would fall far below those of other gas utilities. For example, UNS Gas' FFO interest coverage and its FFO to debt ratio will be far below industry averages.[17] Likewise, under Staff's proposed rates, UNS Gas' net cash flow as a percentage of capital expenditures would be far below the industry average.[18] For example, in 2008, UNS Gas' net cash flow would be only about half of the capital expenditures that will be required. Thus, UNS Gas will have to seek substantial amounts of new capital. If the ROO is adopted, new debt and equity capital would become ever more expensive because UNS Gas would be riskier than other gas companies and it has far weaker financial metrics. Increasing UNS Gas' cost of capital at a time when customer growth is creating such significant capital needs would not serve the long term interests of either ratepayers or shareholders.

Thus, adopting the rates proposed by the ROO would be poor public policy. Moreover, for the same reasons, adopting those rates will fall below the minimum standards established by the United States Constitution. The Constitution recognizes that "the investor has a legitimate

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[16] Ex. UNSG-28 at Ex. KCG-14, page 1.

[17] UNSG-28 at Ex. KCG-14, page 4.

[18] UNSG-28 at Ex. KCG-14, page 2. Note that Professor Morin states that this metric is "a key quantitative determinant of credit quality." Roger A. Morin, *New Regulatory Finance* (2006) at 48.

concern with the financial integrity of the company whose rates are being regulated."[19] The Constitution requires that rates, at a minimum, must:

> ... [b]e enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock.... By that standard the return to the equity owner should be commensurate with the returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[20]

These standards are often called the "financial integrity" and "capital attraction" standards. The rates set by state utility commissions must meet these standards, and any failure to do so violates the takings clause of the United States Constitution.[21]

The rates proposed in the ROO fall well short of the "financial integrity" and "capital attraction" standards. For example, UNS Gas would earn substantially less than the 10% return on equity (which as discussed herein is an artificially low ROE for UNS Gas) proposed by the ROO. UNS Gas simply would have no opportunity to earn a return similar to that of comparable companies. As a small but fast growing utility, UNS Gas is much *more* risky, not *less* risky, than the average gas company. Under the ROO's proposed rates, UNS Gas' financial metrics would fall far below gas industry averages. Moreover, UNS Gas would have substantial difficulty attracting capital, yet it would still need massive amounts of capital to keep up with growth. For example, the Company needs an additional $43 million in capitalization through 2009.[22] If this capital can be obtained at all, it would come be at very steep price, unless the Commission rejects the insufficient rates proposed by the ROO.

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[19] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1943)

[20] *Id.* The *Hope* case also contained a separate holding that rates need not be set using fair value. While the United States Constitution does not require the use of fair value, the Arizona constitution does require fair value. *See Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956)(Commission cannot use *Hope* case to avoid fair value). *Simms* did not, and could not, authorize the Commission to set rates below the constitutional minimum standard established in *Hope.*

[21] *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308-310 (1988).

[22] Ex. UNSG-27 at 27.

D. The ROO rejects CWIP using generic conclusions that are contradicted by the evidence specific to UNS Gas.

The ROO's rationale for rejecting the inclusion of CWIP in rate base does not rest on evidence relating to UNS Gas, but rather on generic considerations such as: (i) that growth is generally positive, (ii) that regulatory lag is sometimes positive, and (iii) that sometimes rate base issues can be avoided by selecting a different test year. These conclusions may be true in some situations unrelated to this case. However, the evidence in this case, specific to UNS Gas, shows that these generic conclusions do not apply to the Company. In evaluating evidence, "general conclusions may not be substituted for an evaluation of the evidence in each case."[23] Therefore, the Commission should reject the generic conclusions in the ROO and base its decision on the specific evidence relating to UNS Gas.

For example, the ROO cites testimony from RUCO that growth in some situations actually "has a positive aspect due to the increased of revenues associated with serving new customers."[24] The ROO also points to similar testimony by Staff that CWIP might cause a mismatch due to the revenues associated with new customers.[25] The facts show that for UNS Gas the extra revenue from new customers is much less than the costs of serving those customers. For example, in 2006, UNS Gas added $17 million in net plant, resulting in an additional $3 million in fixed costs (depreciation, interest, property taxes, etc).[26] But new customers added in 2006 provided only $1.8 million in new revenues.[27] Therefore, UNS Gas incurred a revenue *deficiency* of $1.2 million due to new growth in 2006.[28] Notably, Staff and RUCO did not dispute this example in their testimony. There can be no real argument, then, that for UNS Gas growth is not the financial

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[23] *Butler Township Water Co. v. Pennsylvania Public Utility Comm'n,* 473 A.2d 219, 221-222 (Pa. Cmwlth. 1984).

[24] ROO at 6:24-25.

[25] ROO at 6:11-12.

[26] Ex. UNSG-28 at 10.

[27] Id.

[28] Id.

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positive that Staff and RUCO have hypothesized. The Commission's decision here should not be based on generic concerns that are contradicted by specific evidence relating to UNS Gas.

Along similar lines, the ROO speculates that "the regulatory lag inherent in utility regulation may provide benefits… and thereby help to mitigate periods of higher plant investment associated with customer growth."[29] While that may be true for some utilities, it is not the case for UNS Gas. As already described, the higher costs associated with new UNS Gas customers creates a severe drain on UNS Gas' financial integrity. Growth also negatively impacts cash flow, because new plant creates additional fixed costs, and because growth leads to capital requirements far in excess of the Company's internal cash flow.[30] As a result, the "impact of regulatory lag on UNS Gas is more pronounced than for most utilities."[31] As Moody's recently explained, a key factor in a utility's financial health is the "degree of regulatory lag" because high, recurring regulatory lag depresses cash flow and results in higher leverage and weaker credit metrics.[32] While regulatory lag may be positive for some companies, UNS Gas suffers much more from regulatory lag than most utilities – a fact that has real impacts on its financial health. The Commission's decision should be based on evidence regarding UNS Gas, not speculation about other utilities.

The ROO further notes that CWIP was used back in the 1980s for Arizona Public Service ("APS") to address the impacts of building Palo Verde. The ROO implies that UNS Gas is in a much better position than APS was at that time. However, UNS Gas does share the same problem that APS was facing, namely a large construction program and weak operating cash flows.

Finally, the ROO criticizes UNS Gas for even raising these issues, stating that "[a]s we have stated in prior cases, regulated utility companies control the timing of their rate case filings and should not be heard to complain when their chosen test periods do not coincide with the

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[29] ROO at 7:3-5.

[30] Ex. UNSG-28 at 9.

[31] Ex. UNSG-27 at 28.

[32] Ex. UNSG-28 at 12-13.

completion of plant that may be considered used and useful and therefore properly included in rate base."[33] The ROO misses an important point. UNS Gas was precluded by the Commission for three years from filing a rate case. UNS Gas was severely limited by the Commission as to when it could file for rate relief and what test year it could use to seek such relief. If the Company had not been precluded by the Commission from seeking rate relief sooner, the timing of the request for relief sought in this case and many of the issues certainly would have been different. But the Company must deal with reality and not generic observations. The Commission's decision should be based on the evidence in this case, not conclusions or evidence from other cases about other companies. Moreover, under the ROO's logic, CWIP would never be available to any company – despite the fact that it is allowable and has been used in the past. In some cases, utilities may be able to avoid problems by selecting better test years. For example, if a utility is nearing completion of a large plant, in some circumstances it may wait until that plant is in service before filing the rate case. But the CWIP incurred by UNS Gas does not typically result from a single large project. Rather it incorporates a multitude of small, recurring projects. Thus, on any particular date, UNS Gas will always have substantial amounts of CWIP. For example, UNS Gas' year-end CWIP balances were as follows (from Schedule E-1):

Year	**CWIP at year end**
2003	$ 9,916,507
2004	$10,786,699
2005	$ 7,189,231

Hence, for UNS Gas, CWIP is not a problem that can be avoided by simply selecting a different test year.

This rationale could create inappropriate incentives – potentially endorsing the view that utilities should base plant decisions on regulatory strategies, rather than on customer needs and sound engineering practices. In some situations, this approach would encourage utilities to build

[33] ROO at 9:24-27.

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plant before it is needed, just so it meets the end of the test year. In other situations, it would encourage utilities to delay needed projects until a test year is near to minimize the time between when the project is finished and when it is included in rates. The Commission should soundly reject this approach.

For all the foregoing reasons, the Commission should amend the ROO and include $7.2 million of CWIP in rate base.

II. ALTERNATIVELY, THE EVIDENCE IN THIS CASE SUPPORTS THE INCLUSION OF POST TEST YEAR PLANT IN RATE BASE.

UNS Gas has requested that, alternatively, $6.8 million of Post Test Year Plant be included in rate base. The ROO rejects the Company's request in its entirety and precludes post test year rate base from rate base. For the same reasons as set forth for CWIP, post test year plant should be in rate base in order for just and reasonable rates to be set for the Company at this time.

If the Commission does not allow CWIP into rate base, then it should include post test year plant in rate base. The Commission approved post test year plant in a number of recent cases.[34] UNS Gas faces faster growth than other utilities in Arizona.[35] Given the large number of other cases approving post test year plant, it is certainly justified in this case. The only factor the ROO mentions against using post test year plant is the possibility of a mismatch due to extra revenues relating to the new plant.[36] However, as already shown, revenues from new customers do not come close to covering the fixed costs related to those new customers.. Thus, unless some adjustment is made, UNS Gas will continue to realize a sizeable revenue deficiency on the post test year assets. The record in this docket shows that $5.1 million of the $7.2 million in CWIP was

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[34] *See e.g.*, *Arizona-American Water Co. (Paradise Valley),* Decision No. 68858 (July 28, 2006); *Chaparral City Water Co.,* Decision No. 68176 (September 30, 2005); *Rio Rico Utilities, Inc.*, Decision No. 67279 (October 5, 2004); *Arizona-American Water Co.*, Decision No. 67093 (June 30, 2004); *Arizona Water Co.*, Decision No. 66849 (March 19, 2004); *Bella Vista Water Co., Inc.*, Decision No. 65350 (November 1, 2002).

[35] Ex. UNSG-29 at Ex. KCG-15; Tr. at 920, 1004-5, 1020.

[36] ROO at 8.

in service within five months of the end of the test year and $6.8 million was in service within twelve months after the test year.[37]

Accordingly, the Commission should amend the ROO to include $6.8 million of post test year plant in rate base.

III. IF THE COMMISSION FAILS TO ALLOW CWIP IN RATE BASE, IT SHOULD NOT FURTHER PENALIZE UNS GAS BY DEDUCTING CWIP-RELATED ADVANCES.

If CWIP or Post Test Year Plant is not included in rate base, then the Company should not be penalized further by the deduction from rate base of $4 million in customer advances related to the CWIP. The Commission should not further harm the Company's financial integrity by allowing the deduction.

Allowing CWIP or post-test year plant into rate base would be the best solution to addressing the financial problems UNS Gas faces due to growth. But if these alternatives are not chosen, then at the very least, the Commission should not further penalize UNS Gas by deducting from rate base advances related to CWIP. Doing so hurts the Company twice – not only are needed CWIP amounts not added to rate base, but rate base is actually reduced by something that had not been in rate base.

Generally, advances are deducted from rate base because customer-supplied advances are a "cost-free" source of capital for the utility. For example, if UNS Gas uses a $10,000 advance to construct plant that is in service, the net effect is zero, as follows:

Plant in service:	+ $10,000
Offset for advances:	- $10,000
Net impact on rate base:	$0

[37] See Attachment 1 to this Brief.

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In this example, deducting advances from rate base works as intended, resulting in no change to rate base. However, when the advance will be used to pay for plant that is not yet in rate base, the calculation breaks down – which is the case here:

Plant in service:	+	$0
Offset for advances:	- $10,000	
Net impact on rate base:	- $10,000	

In this situation, the utility's existing rate base, which was financed with investor-supplied capital is arbitrarily reduced by $10,000. Of course, if the problem were limited to $10,000 it would be of only theoretical interest. UNS Gas, though, has $4 million in advances related to CWIP.[38] The effect of excluding these customer advances from rate base is to wipe $4 million of existing capital off the books for purposes of setting rates. Such a confiscation of capital is unfair.

The ROO speculates that had UNS Gas not requested CWIP "there would presumably not have been an issue with respect to… deducting advances from rate base."[39] The word "presumably" infers that this statement is not supported by any evidence. That statement is wrong. Even if UNS Gas never proposed CWIP, it is unreasonable to assume that UNS Gas would allocate $4 million of CWIP-related customer advances to plant in service that has already be financed with investor-supplied capital.

For most utilities, the recommended treatment of customer advances is a minor inconvenience. But for UNS Gas it is a serious problem. The Commission recently recognized that when the amounts have a real impact on the company, this effect is not fair. In that case, Arizona-American Water Company asked for a hook-up fee increase to pay for a water treatment plant. Hook-up fees are treated as contributions, and for water companies, contributions are deducted from rate base like advances. Because the plant will take some time to build, Arizona-American will collect a lot of contributions before the plant is operational. That would cause rate base to "decline rapidly as hook-up fees are collected, only to bounce back as plant enters

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[38] Ex. UNSG-29 at 9.

[39] ROO at 9.

service."[40] The Commission recognized such a result would harm both customers and the utility, and it therefore ordered the additional contributions to not be deducted from rate base.[41]

The same reasoning applies here. Deducting the advances would reduce UNS Gas' rate base by $4 million. In the next rate case, though, the Company's rate base will increase by $7 million (the amount of CWIP, which by that time will all be in service). Such a "bounce back" effect makes no sense and harms the Company.

The Commission should amend the ROO by not deducting the $4 million in CWIP related advances from rate base, if it does not allow CWIP in rate base.

IV. THE COMMISSION SHOULD RECOGNIZE THE GEOGRAPHIC INFORMATION SYSTEM (GIS) IN RATE BASE.

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UNS Gas requests that $897,098 be included in rate base to reflect the cost of its GIS. The ROO proposes to reject the rate base adjustment because the Company did not previously request an accounting order. However, the Commission should include the GIS costs in rate base because the GIS system was required by the Commission and is providing substantial cost-effective benefits to the Company.

Staff directed that the GIS project be undertaken and thus requiring the Company to incur these costs.[42] The Commission "must consider" the costs of complying with the Commission's requirements. *Arizona Corp. Comm'n v. Palm Springs Utility Co., Inc.*, 24 Ariz. App. 124, 130, 536 P.2d 245, 251 (1975). Because the GIS costs were incurred at the request of the Commission's representatives, the Commission should allow recovery of these costs.

UNS Gas' GIS is a prime example of increasing productivity through increased use of information technology.[43] It was undisputed that the GIS creates many benefits, including:

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[40] *Arizona –American Water Co.,* Decision No. 69914 (September 27, 2007) at 7.
[41] Id. at 29.
[42] Id.
[43] Id. at 6.

(i) Faster emergency response due to the ability to quickly locate system controls (such as valves);

(ii) Better informed planning through computer modeling of the gas system;

(iii) Faster work processes, including quicker mapping of the system, which is especially important in a fast-growing system; and

(iv) Increased accuracy and safety because field employees can access up-to-date maps on their portable computers.[44]

The GIS therefore provides clear benefits in safety and productivity that benefit customers. UNS Gas therefore requests that it be allowed to recover the GIS costs as a regulatory asset.

The ROO proposes that these costs be denied because UNS Gas failed to request an accounting order.[45] RUCO and Staff have not said they would have opposed an accounting order if one had been requested earlier, and they have not questioned the amount of GIS costs or the substantial benefits of the GIS system. An accounting order is not necessary to include a used and useful asset – implemented at the direction of the Commission – in rate base. Rate cases should reflect the economic reality of the costs incurred at the direction of the Commission rather than regulatory technicalities.

The Commission should amend the ROO to include $897,098 in rate base to reflect the cost of the GIS that the Commission directed UNS Gas to undertake.

V. THE COMMISSION SHOULD GRANT A REASONABLE RETURN ON EQUITY.

UNS Gas requests a return on equity ("ROE") of 11.0%, which reflects the specific circumstances of UNS Gas and its commensurate level of risk. The ROO rejected the Company's request and proposes adopting Staff's recommended ROE of 10.0%, which is 75 basis points less than was recently granted to APS, a larger and less riskier company. The Commission should grant UNS Gas an ROE of 11.0% to reflect the specific circumstances of UNS Gas.

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[44] Id. at 6-7.

[45] ROO at 10-11.

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The ROO adopts Staff's ROE recommendation, which was made by Mr. Parcell. Mr. Parcell is no stranger to the Commission – he has been involved in many recent cases. One of those cases was the recent APS rate case. In the APS case, Mr. Parcell used the same methods he used in this case.[46] In the APS case, the Commission did not follow Mr. Parcell's recommendation.[47] But the ROO in this case adopts Mr. Parcell's recommendation without change. Since Mr. Parcell's methods have not changed, the Commission's ruling should similarly reject his recommendation in this case. In the APS case, the Commission adopted an ROE 50 basis points higher than Mr. Parcell recommended, resulting in an ROE of 10.75%. Applying the same 50 basis point adder here would result in an ROE of at least 10.5%.

There are obvious differences between APS and UNS Gas that further justify an 11% ROE for the Company. UNS Gas is much smaller, is not paying a dividend, and is growing much faster in terms of net plant investment. Those factors suggest that UNS Gas is more risky than APS, and should therefore have a higher ROE. Thus, UNS Gas' proposed ROE of 11% is fully supported in the record through the Company's testimony. But at the very least, UNS Gas should be allowed an ROE consistent with the APS case.

In order to reflect the evidence in this case and be consistent in its approach with regards to ROE, the Commission should amend the ROO and grant UNS Gas an ROE of 11.0%.

VI. THE COMMISSION SHOULD INCREASE UNS GAS' MONTHLY CHARGE TO REDUCE THE SIGNIFICANT EXISTING CROSS SUBSIDY BETWEEN COLD WEATHER AND WARM WEATHER CUSTOMERS.

UNS Gas proposes increasing its monthly charge to residential customers from $7.00 per month to $17.00 per month and decreasing its base volumetric charge to ameliorate substantial cross-subsidization of warm weather customers by cold weather customers. The ROO rejects the Company's proposal and adopts Staff's proposed monthly charge of $8.50, which would leave in

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[46] Compare ROO at 43-45 to *Arizona Public Service Co.,* Decision No. 69663 (June 28, 2007) at 46-49.

[47] *Arizona Public Service Co,* Decision No. 69663 (June 28, 2007) at 49.

place inequitable cross subsidies. Continuing these cross subsidies is not in the public interest. And the monthly charges should more closely reflect the fixed monthly costs caused by each customer.

Currently, UNS Gas' cold weather customers are paying a substantial subsidy to its warm weather customers. For example, under current rates, a residential customer in Flagstaff pays almost twice as much for the Company's fixed costs as a residential customer in Lake Havasu City.[48] In fairness, this subsidy should be reduced. Therefore, UNS Gas proposes increasing the monthly charge from $7 to $17 a month. An offsetting reduction to the volumetric price of gas means that an average customer's overall bill would increase only a few percent.[49] This rate design will reduce the large subsidy cold weather customers pay for the benefit of warm weather customers. A higher monthly charge will reduce that cross-subsidy.

This new rate design also would also create a better match between fixed revenues and fixed costs. Presently, UNS Gas incurs $26 per month in fixed costs to serve a customer. The monthly customer charge, though, is just $7. The current rate design only collects approximately 25% of fixed distribution costs through the monthly customer charge.[50] The ROO proposes a small increase to $8.50. Under that increase, only 30% of fixed distribution costs will be recovered through the monthly customer charge.[51] While the ROO trumpets this as a "significant movement towards cost-based rates," the modest change of 5% would still leave 70% of fixed costs to be recovered though variable volumetric charges.

While UNS Gas appreciates the goal of "gradualism", cold weather customers should not be required to pay a large subsidy for an undue period of time. Cold weather customers have the largest bills, and are thus least able to afford such a subsidy. Ironically, the ROO's monthly charge is still less than the monthly charge of $9.70 approved in the last Southwest Gas rate case.[52]

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[48] Ex. UNSG-18 at 8 and Ex. TLV-1 thereto.

[49] See UNS Gas Final Schedules, Schedule H-4.

[50] Tr. at 445.

[51] See Tr. at 445.

[52] *Southwest Gas Corp.,* Decision No. 68487 (February 23, 2006) at 38.

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Southwest Gas does not have the cold weather Northern Arizona service that UNS Gas does. Therefore, it likely has much less of a cross-subsidy problem. Thus, UNS Gas should have a higher monthly charge than Southwest Gas – but at the very least it should not be lower than Southwest Gas.

The Commission should amend the ROO and approve a monthly charge of $17 to reduce existing significant cross subsidies and to more closely match the monthly charge to actual fixed costs per customer.

VII. THE COMMISSION SHOULD ALLOW UNS GAS TO RECOVER ALL PRUDENTLY INCURRED EXPENSES.

UNS Gas has requested recovery of several categories of expenses. The Company has prudently incurred the expenses requested in this rate case, has provided proof of those expenses, and is, therefore, entitled to recovery of those expenses. However, the ROO has reduced recovery of certain expenses even though there is no evidence in the record that expenses were imprudent or not incurred. In particular, the ROO has reduced rate case expenses, certain employee compensation expenses and a category of small expenses. The Commission is obligated to allow recovery of prudently incurred expenses.

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A. Utility commissions are required to provide recovery of operating expenses.

Under the United States Constitution, utility commissions are required to provide recovery of both operating expenses and capital costs.[53] And under the Arizona Constitution, the Commission is further required "to allow a recovery for all reasonable expenses."[54] In other words, the Commission must provide sufficient income to permit full recovery of "operating costs" in addition to the return on rate base.[55] In addition, the Commission "must consider" any "expenditures made in compliance with the Commission's decision[s]."[56]

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[53] *See Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1943).

[54] *Tucson Electric Power Co. v. Arizona Corp. Comm'n,* 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982).

[55] *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978).

[56] *Arizona Corp. Comm'n v. Palm Springs Utility Co.*, 24 Ariz. App. 124, 536 P.2d 245 (1975).

In evaluating costs under this framework, the utility's expenses are presumed to be reasonable and incurred in good faith.[57] While the utility bears the initial burden of proof, once the utility makes a "prima facie case for the reasonableness of its operating expenses... [t]he burden then shifts to the [adverse party] to show by substantial, competent evidence that the expenditures were unreasonable by reason of inefficiency or bad faith."[58]

B. UNS Gas is entitled to its requested Rate Case Expense.

UNS Gas requested $900,000 in rate case expenses. Without considering the Company's actual rate case expenses, the ROO proposes reducing the rate case expenses to the amount allowed Southwest Gas in its most recent rate case. However, unlike UNS Gas, Southwest Gas conducts its rate case almost entirely with in-house personnel who are on salary. Moreover, UNS Gas' requested rate case expenses were prudently incurred and reflect the cost of its first rate case, including over twice the discovery from Staff and intervenors than was conducted in the Southwest Gas case.

1. The comparison with Southwest Gas is invalid.

The ROO allows UNS Gas to recover only one-third of its requested rate case expense. The ROO bases this decision on a comparison to the rate case expense allowed in the recent Southwest Gas rate case, stating that "Southwest Gas is an appropriate measure of comparison for UNS Gas."[59] This conclusion is flawed for several reasons. Most fundamentally, rate case expense cannot be judged by comparisons to other utilities. This is because rate case expense is "highly specific to the particular utility and the particular rate case in question" and therefore rate case expense in one case legally has "no bearing" on what should be allowed in another case.[60]

Moreover, even if it was valid to compare rate case expenses of different utilities, the evidence shows that Southwest Gas differs from UNS Gas in key ways that make their expenses

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[57] *West Ohio Gas Co. Public Utility Comm'n of Ohio*, 294 U.S. 63, 72 (1935).

[58] *Boise Water Corp. v. Idaho Public Utilities Comm'n*, 555 P.2d 163, 169 (Idaho 1976).

[59] ROO at 22:9.

[60] *City of Lancaster (Sewer Fund) v. Pennsylvania Public Utility Comm'n*, 793 A.2d 978, 982-984. (Pa. Cmwlth. 2002).

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not directly comparable. Southwest Gas has an entire department of rate experts, as well as in-house lawyers, to manage its rate cases. The cost of those resources is included in Southwest Gas' overall overhead and administrative expenses, and therefore is excluded from rate case expense. In contrast, UNS Gas does not have those resources and must rely on outside services from TEP and other vendors. Therefore, it is no surprise that UNS Gas' rate case expense is much higher. Moreover, if UNS Gas followed Southwest Gas' methodology, several other expenses would be higher. The evidence is clear:

- Southwest Gas' internal personnel and support services are built into its base rates; in contrast, UNS Gas does not have those costs built in and must recover them through the rate case expense.[61]
- Southwest Gas' overhead costs for rate cases, including in-house experts, lawyers, and support and administrative personnel, are allocated using the Massachusetts formula to the three states it serves. UNS Gas does not have the same structure. When TEP employees perform UNS Gas activities, those activities must be directly recorded so that only those costs are charged to UNS Gas.[62]
- If UNS Gas used the Southwest Gas Massachusetts Formula, its test-year expenses would be $2.5 million higher.[63]
- UNS Gas received 605 data requests from Staff and intervenors, including 440 of those with subparts. Southwest Gas received only 285 data requests, including only 206 with subparts.[64]

Staff and RUCO do not dispute the evidence concerning those differences. So there should be no dispute that any comparison of rate case expense between Southwest Gas and UNS Gas is deeply flawed. Although these differences were not contested at the hearing, the ROO does not consider

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[61] Ex. UNSG-13 at 33-35.

[62] Ex. UNSG-13 at 33-35; Ex. UNSG-14 at 9-11; Tr. at 281, 887-88.

[63] Ex. UNSG-14 at 10.

[64] Ex. UNSG-13 at 34-35.

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them. Instead, the ROO cites RUCO's testimony that both companies "extensively used in-house staff" for rate cases and are therefore comparable.[65] Under cross-examination, though, RUCO's witness, Mr. Moore, testified that UNS Gas does not have in-house staff for most rate case functions.[66] It was TEP's staff that performed the rate case work. Thus, any comparison between UNS Gas and Southwest Gas is wholly discredited. Moreover, the courts have recognized that whether a utility has in-house staff is a specific, legitimate reason for rate case costs to differ between utilities.[67]

2. *The Commission should reject Staff's vague, last-second "concerns".*

Perhaps recognizing the weakness of the comparison to Southwest Gas, the ROO points to the testimony of Staff's hired lawyer/expert, Mr. Ralph Smith.[68] Mr. Smith did not propose an adjustment to the Company's rate case expense in his Direct Testimony. In Surrebuttal Testimony, however, he adopted RUCO's adjustment which was based on the comparison to Southwest Gas.[69] On the stand, Mr. Smith was unable to support this adjustment, testifying that he was not familiar with Southwest Gas' accounting.[70] Recognizing that his comparison to Southwest Gas was therefore discredited, on re-direct and re-cross, Mr. Smith attempted to articulate a new justification for the disallowance.[71] Although the exact basis of Mr. Smith's on-the-fly justification is unclear, it has something to do with a vague concern over UniSource Energy's overall allocation methods. Notably, this "concern" was not limited to rate case expense, yet Staff proposed no other adjustment based on this supposed concern.

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[65] ROO at 21:12-14.

[66] Tr. at 623, 629-30.

[67] *City of Lancaster (Sewer Fund) v. Pennsylvania Public Utility Comm'n*, 793 A.2d 978, 982-984. (Pa. Cmwlth. 2002).

[68] ROO at 21-22. The testimony cited by the ROO was on re-cross, not cross-examination as stated in the ROO.

[69] Ex. S-27 at 42-44.

[70] Tr. at 886-894.

[71] Tr. at 895-898.

Whatever Mr. Smith's new concern, it should not be considered because it was not included in pre-filed testimony. Staff, like the other parties, was ordered to pre-file its testimony. The Commission recently rejected a similar attempt by Staff to introduce a new argument at hearing, explaining "the timing of Staff's changed recommendation is problematic because it did not afford other parties an opportunity to explore fully the underlying basis of Staff's proposal."[72] The same is true here. Indeed, this example is even more problematic because Staff waited until re-direct and re-cross to introduce its new argument. As such, other parties were not afforded a fair opportunity to explore this new argument.

3. *The Commission must approve prudent rate case expenses.*

Rate case expense is included under the general principle that utility commissions must allow recovery in rates of all prudently incurred expenses.[73] Therefore, the Commission is required to allow recovery of prudently incurred rate case expense.[74] Disturbingly, Mr. Smith refused to state that the Commission should allow recovery of prudent rate case costs.[75] No party has disputed the amount of rate case costs incurred by UNS Gas. Nor has any party argued that UNS Gas' overall conduct of the case, or any specific arguments or actions, was unreasonable. A reduction or disallowance in rate case expense can be justified when the rate case is "abortive or frivolous"[76] A reduction also can be justified by a showing that "any particular expenditure… [was] unreasonably or excessively incurred."[77] No party has attempted to show that UNS Gas' rate case expense is imprudent using one of these methods. Thus, UNS Gas' rate case expense is prudent and should be recovered in rates.

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[72] *Arizona-American Water Co. (Mohave),* Decision No. 69440 (May 1, 2007) at 15.

[73] *Butler Township Water Co. v. Pennsylvania Public Utility Comm'n*, 473 A.2d 219, 221-22 (Pa. Cmwlth. 1984).

[74] *Id.*

[75] Tr. at 897-898.

[76] *Maine Water Co. v. Public Utilities Comm'n*, 482 A.2d 443, 453 (Me. 1984).

[77] *City of Lancaster (Sewer Fund) v. Pennsylvania Public Utility Comm'n*, 793 A.2d 978, 982-984. (Pa. Cmwlth. 2002).

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The Commission should amend the ROO and approve the Company's full request for $900,000 in Rate Case Expenses.

C. UNS Gas is entitled to its requested Employee Compensation Expenses.

UNS Gas requested to recover $137,262 in expenses for three incentive compensation programs: the Performance Enhancement Program, the Supplemental Executive Retirement Plan and the Officer's Long-Term Incentive Program. No party argued that UNS Gas' overall level of employee compensation expenses was imprudent. Indeed, UNS Gas' average cash compensation is below that of comparable firms.[78] That should be the end of the matter, and as there is no issue of prudence, UNS Gas' employee compensation expenses should be recovered in rates. Although the ROO does not claim that overall employee compensation costs are imprudent, it nevertheless disallows parts of three specific components of those costs.

1. Performance Enhancement Program ("PEP").

First, the ROO disallows 50% of UNS Gas' Performance Enhancement Program ("PEP") costs. The ROO euphemistically calls this "sharing" between ratepayers and shareholders based on the notion that PEP benefits both shareholders and ratepayers. But this could be said of any expense incurred by UNS Gas. The test is not who benefits, but rather whether the costs are prudent. Courts have made clear that such "sharing" theories based on mutual benefits are wholly illegitimate.[79] The Commission must allow recovery of the full amount of prudent costs. Moreover, the ROO is inconsistent with the recent APS rate order, which did not impose any restriction on the recovery of costs stemming from APS' similar cash-based incentive compensation program – which is the same type of cash-base compensation program as the PEP.

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[78] UNSG-13 at 9.

[79] *See Citizens Utility Board v. Illinois Commerce Comm'n*, 651 N.E.2d 1089, 1096-1100 (Illinois 1995)(rejecting sharing of environmental clean-up costs); *Butler Township Water Co. v. Pennsylvania Public Utility Comm'n*, 473 A.2d 219, 221-22 (Pa. Cmwlth. 1984)(rejecting 50/50 sharing of rate case costs based on "shared benefits" theory).

2. *Supplemental Executive Retirement Plan ("SERP").*

Second, the ROO disallows 100% of UNS Gas' Supplemental Executive Retirement Plan ("SERP"). This decision is especially disconcerting because during the test year, UNS Gas had every reason to believe that SERP costs were recoverable. The most recent guidance available was the 2001 Southwest Gas rate order, which allowed full recovery of SERP costs.[80] Only after the test year the Commission change course and reject SERP costs in the 2006 Southwest Gas rate order. UNS Gas deserves to know what the rules are in advance, rather than having to guess at what principles the Commission will change in the future.

For example, if UNS Gas had known that SERP costs were not allowable, it could have increased base compensation instead. UNS Gas' overall employee compensation costs are prudent and that cash compensation is lower than comparable companies. Notwithstanding any evidence of imprudence, the ROO accuses UNS Gas of attempting to "disguise the costs" and playing "a veritable regulatory version of "Three-Card Monte".[81] This rhetoric is regrettable and should not be included in the final order issued by the Commission. There is nothing disguised about increased base compensation, which is apparent for all to see. And any party could attempt to show that the base compensation was imprudent.

3. *Officer's Long-Term Incentive Program.*

The third disputed component of employee compensation is the officer's long-term incentive program. UNS Gas noted the dispute about this program in its brief.[82] The ROO does not contain a ruling on this dispute but the overall expense level appears to exclude 50% of its cost. At the very least, UNS Gas is entitled to a ruling on this point. The substance of that ruling should be an affirmation of this program. Like the PEP, this program provides incentive compensation that helps make up for UNS Gas' below average base pay while also providing employees with an economic incentive to perform well.

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[80] *Southwest Gas Corp.*, Decision No. 64172 (October 30, 2001) at 14-15.

[81] ROO at 28:22-27.

[82] UNS Gas Initial Brief at 28.

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The Commission should amend the ROO to allow UNS Gas full recovery of its $137,262 in expenses for its employee incentive compensation programs.

D. UNS Gas is entitled to recover all of its requested "Small Expenses".

The ROO proposes disallowing recovery of 50% of 1,995 small UNS Gas expenses – a disallowance totaling $116,674. In so doing the ROO accepts RUCO's assertion that some these small expenses <u>might</u> be questionable,[83] theorizing that otherwise, ratepayers might suffer "the proverbial 'death by 1,000 cuts.'"[84] However, RUCO's witness, Mr. Moore, failed to detail any imprudence in the expenses and only provided a general explanation of why he questioned these 1,995 expenses.[85]

UNS Gas' general manager, Mr. Gary Smith, testified that most of these expenses "are directly related to safety, system integrity and operator training."[86] Mr. Smith then explained the necessity of various categories of expenses on Mr. Moore's list. For example, Mr. Smith explained that most of the expenses related to travel for "regulatory-mandated functions such as leak surveys, safety audits, and training" and other expenses including "participation in the annual-mandated Commission pipeline safety audit and required operator qualification training, welder qualification training, and emergency response testing."[87] Many of the remaining expenses are for "small tools that are necessary for maintaining the pipeline system."[88] Mr. Moore's Surrebuttal Testimony did not contest Mr. Smith's explanation.

Thus, UNS Gas has provided a prima facie showing of the legitimacy of these expenses. The burden of proof therefore shifts to RUCO to show that they are imprudent. RUCO did not respond at all to the showing made by UNS Gas' general manager, and therefore failed to meet its

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[83] ROO at 24-25.

[84] ROO at 26:1-2.

[85] To limit disagreements, UNS Gas agreed to remove the few specific expenses Moore challenged.

[86] Ex. UNSG-16 at 5-6.

[87] Id.

[88] Id.

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burden of proof. Moreover, it makes no sense to require 1,995 specific responses to a general objection. UNS Gas responded to RUCO's general objection with an explanation, which RUCO did not challenge further. That is all that is required, and these costs should be allowed in full.

The Commission should amend the ROO to allow recovery of the full amount of the $233,347 in "small expenses".

VIII. THE COMMISSION MUST USE FAIR VALUE TO SET RATES.

In response to the Arizona Court of Appeals decision in Chaparral City Water Company, UNS Gas proposed to use the weighted average cost of capital as the rate of return for fair value rate base, but agreed that the rate increase in this case should be no greater than the increase proposed in its application. The ROO, however, adopted Staff's proposed methodology, which was the mathematical equivalent of the methodology struck down in Chaparral City. The Commission should not adopt a methodology that has been found to violate the Arizona Constitution.

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A. The Commission should abandon the discredited "backing-in" method.

1. Staff used the unlawful backing-in method.

The ROO follows Staff's approach regarding the use of the fair value rate base. Staff's approach is to "re-cast" its cost of capital as a "fair value cost of capital."[89] In other words, Staff "lowered the overall ROR applied to fair value rate base in order to achieve the same level of operating income calculated using Mr. Parcell's cost of capital and Staff's original cost rate base."[90] This approach is often called the "backing-in" method because the revenue requirement is determined using the cost of capital and the original cost rate base; the fair value numbers are the result of a meaningless, after-the-fact exercise.

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[89] Ex. S-37 at 9.

[90] Ex. UNSG-28 at 28.

Staff has clearly used this same discredited "backing-in" method here. The uncontraverted evidence is that Staff's approach in this case "is mathematically equivalent" to methods that are not permissible.[91] The Commission should reject this unlawful, discredited method.

2. Staff's approach ignores fair value.

Staff's witness, Mr. Parcell, candidly admitted that under his approach, fair value has no impact on rates. Under his approach, otherwise identical companies will have the same rates, even if their fair value rate base differs.[92] Parcell testified that, all other factors remaining equal, the following three hypothetical companies have the same return dollar requirement:[93]

Company	Original Cost Rate Base	Fair Value Rate Base	Return Dollar Requirement
1	$10 million	$ 10 million	Same for all three
2	$10 million	$ 20 million	Same for all three
3	$10 million	$100 million	Same for all three

Under Staff's approach, fair value simply has no impact on rates.

3. The Commission must use fair value.

The Arizona Constitution contains a clear command: "The Corporation Commission shall… ascertain the fair value of the property within the State of every public service corporation doing business therein"[94] Fair value is not optional. As the Arizona Supreme Court recently held, the fair value section "is an imperative… [t]he constitutional provision in question does not… say or imply anything about the existence of discretion in the commission."[95] Not only is the

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[91] Ex. UNSG-29 at 13.

[92] Tr. at 1027.

[93] Tr. at 1024-1027.

[94] Arizona Constitution, Article 15, § 14.

[95] *U.S. West Communications, Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242, 246, 34 P.3d 351, 355 (2001).

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Commission required to find fair value, but it must also use that fair value finding in ratemaking.[96] Therefore, the Court of Appeals ruled that the Constitution requires "utilization of the fair-value finding" in setting rates.[97]

As shown above, under Staff's approach, fair value has no impact on rates. Although Staff calculates a "fair value rate of return," this calculation can be completed only after the revenue requirement is determined through the "backing-in" method. This after-the-fact calculation is simply a meaningless exercise. The constitutional requirement to use fair value cannot be satisfied when fair value is used merely as window dressing. Staff's approach therefore must be rejected.

The ROO does not deny that it used the "backing-in" method. Nor does the ROO explain how its method amounts to using fair value, when the result will be the same regardless of the amount of fair value.

B. Staff used the illegal "prudent investment" approach.

The ROO completely follows Staff's approach. Staff testified this approach follows the theory that investors should be allowed "a return on the capital they provided the utility" – or, in other words, a "return on their invested capital."[98] Staff then argues that any difference between the original cost and the fair value should be disregarded or assigned a zero cost "because there are no investor-supplied funds supporting the difference between fair value rate base and original cost rate base."[99] Staff's focus on the value of invested capital is called the "prudent investment theory."[100] Whatever the merits of this theory may be, under the Arizona Constitution, the Commission is forbidden to use it.[101] The ban on the use of the prudent investment theory has

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[96] *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956); *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1979).

[97] *Phelps Dodge Corp. v. Arizona Electric Power Co-op*, 207 Ariz. 95, ¶ 38, 83 P.3d 573, 586 (App. 2004).

[98] Ex. S-37 at 8-9.

[99] Tr. at 1016.

[100] *See Simms*, 80 Ariz. at 151, 294 P.2d at 382.

[101] *Id.*; *Consolidated Water Utilities, Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 141, 875 P.2d 137, 482 (App. 1994); *City of Tucson v. Citizens Utilities Water Co.*, 17 Ariz. App. 477, 482, 498 P.2d 551, 556 (1972).

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been made very clear by the Arizona Supreme Court: "[the] Commission cannot be guided by the prudent investment theory.... The amount invested is immaterial."[102] As the court explained, "under the law of fair value a utility is not entitled to a fair return on its investment; it is entitled to a fair return on the fair value of its properties devoted to the public use, no more and no less."[103]

C. The ROO's procedural argument should be rejected.

The ROO asserts that UNS Gas' fair value argument must be rejected because it was only raised in rebuttal testimony. The ROO states that if UNS Gas wished to present this argument it should have withdrawn its application and started over again. That approach would result in a delay of at least a year, while UNS Gas is already under-earning and subject to significant financial stress. Moreover, the event that trigged this issue did not happen until shortly before the rebuttal testimony was filed.

More fundamentally, the ROO's claim that this argument is procedurally barred is inconsistent with the treatment of arguments offered by other parties in this case. For example, Staff did not challenge rate case expense in its Direct Testimony, but it was allowed to pursue that issue in its Surrebuttal Testimony and was permitted to introduce an entirely new justification for its position on the stand. If entirely new testimony is permitted during the hearing on significant issues like rate case expense, then UNS Gas' approach of raising the fair value issue in rebuttal testimony prior to the hearing is appropriate.

D. UNS Gas' method is the only permissible method proposed in this case.

All parties, including UNS Gas, have struggled with how to address the renewed emphasis on fair value. Because this issue arose after the application was filed, UNS Gas has agreed that the rate increase in this case should be no greater than the increase proposed in its application. UNS Gas addressed the fair value issue by proposing to use the weighted average cost of capital as the

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[102] *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959).
[103] *Id.*

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rate of return for fair value rate base.[104] This is not the only possible approach. It is, however, the only approach presented in this case that complies with the Arizona Constitution.

The ROO sets up a straw man, stating that UNS Gas argues that this method must be used.[105] The ROO then accuses UNS Gas of being "disingenuous" because the courts have stated that this method is permissible but not required.[106] But UNS Gas never said that this method must be used, and it explicitly stated that there were other permissible methods.[107] The problem in this case is that neither Staff nor RUCO proposed any of the other permissible methods. Instead, Staff and RUCO proposed the one method that is known to be impermissible. Whatever the Commission does, it must not use that method. UNS Gas has presented a permissible option. The Commission can choose that option, or it can devise a different permissible option. But the Commission should reject the ROO's decision to use a clearly illegal method.

The Commission should amend the ROO to adopt UNS Gas's proposal on Fair Value.

IX. TECHNICAL ISSUES ARRISING FROM THE ROO.

A. CARES deferral issue.

UNS Gas proposed continuing the deferral of costs relating to the CARES program. Staff suggested that there be no further deferrals in the future. The ROO adopts this Staff recommendation, and UNS Gas will not challenge that decision. However, under the present system, UNS Gas accumulated a deferred balance of $400,000. Staff, and thus the ROO, did not present a plan for addressing the deferred balance. The deferred balance was accumulated in accordance with existing Commission orders, so something must be done to address this balance. UNS Gas therefore requests that the Commission provide some direction regarding how this deferred balance will be treated. UNS Gas proposes that the Commission allow recovery of these

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[104] Ex. UNSG-28 at 28; Ex. UNSG-29 at 12-13.

[105] ROO at 49:15-18.

[106] ROO at 50:3.

[107] UNS Gas Initial Brief at 42-43.

deferred expenses by amortizing the deferred balance over the same amortization period as rate case expense (i.e. three years, on the assumption that rates will be in effect for that long).

B. Working Capital and other flow through adjustments.

Determining the appropriate level of working capital is dependent, in part, on decisions on other revenue requirement issues. The ROO did not recalculate working capital to reflect all of the decisions on other issues proposed in the ROO. Attached as Attachment 2 is a schedule showing the necessary adjustment. UNS Gas requests that the Commission use the correct level of working capital.

There are a number of other "flow-though" items determined by other revenue requirement decisions. The ROO does not properly adjust some of these items to reflect all of the decisions it proposes on various issues. For example, income tax expense was not recalculated to reflect the final revenue level. Likewise, the ROO did not properly synchronize interest expense to match the proposed rate base and weighted average cost of capital. These additional adjustments are also shown on Attachment 2.

The proper methods for calculating these items are well-understood, and UNS Gas does not anticipate that the rate experts for other parties will dispute the accuracy of these modifications. Overall, these technical calculation errors understate the overall revenue requirement by $279,155. The ROO should be revised to reflect the proper calculation of these items. However, to the extent that the Commission modifies the ROO in other respects, these flow-through items will have to be recalculated to reflect the Commission's decision on those other matters.

X. CONCLUSION.

The Commission should take action to support UNS Gas' financial integrity in the face of an onslaught of growth so that much needed capital can be raised on reasonable terms. The Commission also should reduce the cross-subsidy that cold weather customers would be forced to pay under the rates proposed by the ROO. Further, the Commission should ensure that its order complies with applicable legal standards, including the United States Constitution and the Arizona Constitution.

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Proposed language for amendments relating to each specific argument are included in Attachment 3 as follows:

Amendment	**Issue**
1.	CWIP
2.	Post Test Year Advances
3.	Deduction of Advances
4.	GIS
5.	Return on Equity
6.	Monthly Charge
7.	Rate Case Expense
8.	PEP
9.	SERP
10.	Officer's Incentive Compensation
11.	Small Expenses
12.	Fair Value
13.	CARES Deferral
14.	Technical Corrections

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RESPECTFULLY SUBMITTED this 24th day of October, 2007.

UNS Gas, Inc.

By [signature]
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Original and 17 copies of the foregoing filed this 24th day of October, 2007, with:

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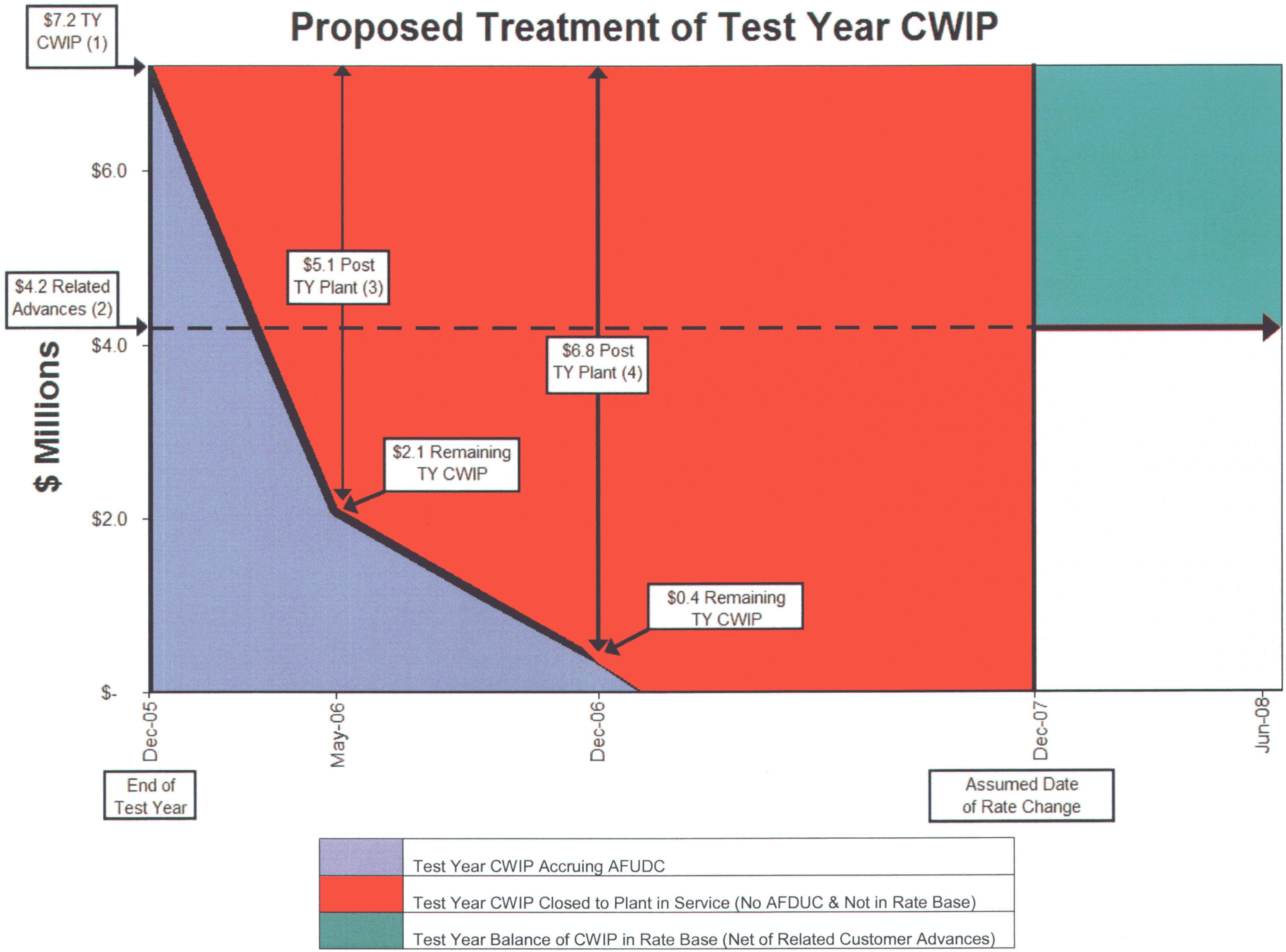
ATTACHMENT

"1"

UNS Gas, Inc.
Proposed Treatment of Test Year CWIP



References
(1) Grant Direct, p. 27 line 16.
(2) Grant Rebuttal, p. 15, line 27.
(3) Grant Direct, p. 28, line 25.
(4) Grant Rebuttal, p. 16, line 10.

ATTACHMENT

"2"

UNS GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005

	Surrebuttal 4/4/07 ACC Staff	ROO As Issued 10/15/07	ROO Corrections 10/15/07	Difference	Description of Correction Adjustment	UNSG Witness
Original Cost Rate Base - Unadjusted	$149,791,159	$149,791,159	$149,791,159	$0		Kissinger
Rate Base Adjustments						
Acquisition Adjustment (RUCO Rate Base Adjustment No. 3)	35,277,589	35,277,589	35,277,589	-		Kissinger
Southern Union Acquisition Premium	(17,053,753)	(17,053,753)	(17,053,753)	-		Kissinger
Griffith Power Plant	(5,254,086)	(5,254,086)	(5,254,086)	-		Kissinger
CWIP (Staff Adjustment B-1, RUCO Rate Base Adjustment No. 4)	-	-	-	-		Grant
Build-Out-Plant	(8,700,572)	(8,700,572)	(8,700,572)	-		Kissinger
CARES Asset	(1,662)	(1,662)	(1,662)	-		Kissinger
GIS Deferral (Staff Adjustment B-2, RUCO Rate Base Adjustment No. 5)	-	-	-	-		Dukes
Pre-Acquisition Plant in Service (RUCO Rate Base Adjustment No. 1)	-	-	-	-		Kissinger
Accumulated Depreciation (RUCO Rate Base Adjustment No. 2)	-	-	-	-		Kissinger
Customer Contributions	-	-	-	-		Kissinger
Other Rate Base (Y2K & Warm Spirit)	-	-	-	-		Kissinger
Accumulated Deferred Income Taxes (Staff Adjustment B-4)	3,003,228	3,003,228	3,003,228	-		Kissinger
Working Capital (Staff Adjustment B-3, RUCO Rate Base Adjustment No. 6)	(2,514,629)	(2,514,629)	(2,394,622)	120,007	Order continued to use the original working capital of $2,514,629 from Surrebuttal of Staff. This is incorrect because of the change in adjustments in this Order. A new working capital has been calculated based on these adjustments.	Kissinger
Total Adjustments	4,756,115	4,756,115	4,876,122	120,007		
Pro Forma Original Cost Rate Base	154,547,273	154,547,272	154,667,281	120,007	Amount in ROO is $154,547,272 but Working Capital had not been updated for the ROO adjustments.	
Requested Rate of Return	8.12%	8.30%	8.30%	8.30%		Grant
Required Operating Income	$12,549,239	$12,827,424	$12,837,384	$9,961		

UNS GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005

	Surrebuttal 4/4/07 ACC Staff	ROO As Issued 10/15/07	ROO Corrections 10/15/07	Difference	Description of Correction Adjustment	UNSG Witness
Original Operating Income - Unadjusted	$10,590,155	$10,590,155	$10,590,155	$0		Kissinger
Operating Income Adjustments						
Operating Revenue Adjustments						
Griffith Plant Operations	(865,152)	(865,152)	(865,152)	-		Dukes
Purchased Gas Cost & Gas Cost Revenue	(75,545,465)	(75,545,465)	(75,545,465)	-		Dukes
Customer Annualization (Staff Adjustment C-1, RUCO Operating Income Adjustment No. 14)	828,115	828,115	828,115	-		Erdwurm
Weather Normalization (Staff Adjustment C-2, RUCO Operating Income Adjustment No. 15)	518,883	518,883	518,883	-		Erdwurm
NSP Revenue & Gas Cost	(15,738,093)	(15,738,093)	(15,738,093)	-		Dukes
CARES	(203,181)	(203,181)	(203,181)	-		Dukes
Total Adjustments to Operating Revenues	(91,004,893)	(91,004,893)	(91,004,893)	-		
Operating Expense Adjustments						
Griffith Plant Operations	(164,614)	(164,614)	(164,614)	-		Dukes
Purchased Gas Cost & Gas Cost Revenue	(75,545,465)	(75,545,465)	(75,545,465)	-		Dukes
NSP Revenue & Gas Cost	(15,269,790)	(15,269,790)	(15,269,790)	-		Dukes
Payroll Expense (Staff Adjustment C-8 & C-9)	317,540	369,928	369,928	-		Dukes
Payroll Tax Expense (Staff Adjustment C-10)	16,559	16,559	16,559	-		Dukes
Pension & Benefits (RUCO Operating Income Adjustment No. 11)	54,594	54,594	54,594	-		Dukes
Post Retirement Medical	57,676	57,676	57,676	-		
Worker's Compensation (Staff Adjustment C-13, RUCO Operating Income Adjustment No. 1)	-	-	-	-		Dukes
Incentive Compensation (Staff Adjustment C-6, RUCO Operating Income Adjustment No. 2)	(130,163)	(130,163)	(130,163)	-		Dukes
Rate Case Expense (RUCO Operating Income Adjustment No. 8; Staff Adjustment No. C-19)	85,000	100,000	100,000	-		Dukes
Bad Debt Expense (Staff Adjustment C-3, RUCO Operating Income Adjustment No. 17)	319,021	317,758	317,758	-		Dukes
Interest On Customer Deposits	16,507	16,507	16,507	-		

UNS GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005

	Surrebuttal 4/4/07 ACC Staff	ROO As Issued 10/15/07	ROO Corrections 10/15/07	Difference	Description of Correction Adjustment	UNSG Witness
Operating Expense Adjustments (cont'd)						
Fleet Fuel Expense (Staff Adjustment C-15, RUCO Operating Income Adjustment No. 13)	61,069	32,646	32,646	-		Dukes
Amortization of GIS Expenditures (Staff Adjustment C-5, RUCO Operating Income Adjustment No. 12)	(840,367)	(840,367)	(840,367)	-		Dukes
Out of Period Expenses (RUCO Operating Income Adjustment No. 19)	(43,743)	(43,743)	(43,743)	-		Dukes
Year-End Accruals	(125,000)	(125,000)	(125,000)	-		Dukes
Advertising & Donations	(16,619)	(16,619)	(16,619)	-		Dukes
Postage Expense (Staff Adjustment C-16, RUCO Operating Income Adjustment No. 4)	116,683	116,683	116,683	-		Dukes
CARES	(458,410)	(458,410)	(458,410)	-		Erdwurm & Dukes
Depreciation & Property Tax for CWIP (Staff Adjustment C-4, RUCO Operating Income Adjustment No. 18)	-	-	-	-		Dukes
Gain on Sale of Prescott Property	(12,437)	(12,437)	(12,437)	-		
Corporate Cost Allocations (RUCO Operating Income Adjustment No. 16; Staff Adj. No. C-18)	117,706	117,706	117,706	-		Dukes
Customer Service Cost Allocations (RUCO Operating Income Adjustment No. 5)	325,422	325,422	325,422	-		Dukes
Depreciation Annualization	3,280	3,280	3,280	-		
Emergency Bill Assistance (Staff Adjustment C-7)	21,600	21,600	21,600	-		Dukes
Nonrecurring FERC Rate Case Legal Expense (Staff Adjustment C-11, RUCO Operating Income Adjustment No. 20)	(311,051)	(88,380)	(88,380)	-		Dukes
Membership & Industry Association Dues (Staff Adjustment C-14, RUCO Operating Income Adjustment No. 9)	(26,868)	(1,523)	(1,523)	-		Dukes
Pre-Acquisition Plant in Service Depr. Expense (RUCO Operating Income Adjustment No. 3)	-	-	-	-		Kissinger

UNS GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005

	Surrebuttal 4/4/07 ACC Staff	ROO As Issued 10/15/07	ROO Corrections 10/15/07	Difference	Description of Correction Adjustment	UNSG Witness
Operating Expense Adjustments (cont'd)						
Unnecessary Expenses (RUCO Operating Income Adjustment No. 6)	-	(116,674)	(116,674)	-		Smith/Dukes
Nonrecurring Expenses (RUCO Operating Income Adjustment No. 10)	-	(2,584)	(2,584)	-		Smith
Property Taxes (Staff Adjustment C-12, RUCO Operating Income Adjustment No. 7)	1,511,080	1,511,080	1,511,080	-		Kissinger
Income Taxes (Staff Adjustment "All C's", RUCO Operating Income Adjustment No. 22)	(394,329)	(411,896)	(251,325)	160,571	Calculated based on adopted adjustments and proper synchronization of interest to reflect the capital structure proposed in the ROO.	Kissinger
RUCO Operating Income Adjustment No. 20	-					Dukes
Total Adjustments to Operating Expense	(90,315,119)	(90,166,226)	(90,005,655)	160,571		
Total Net Adjustments	(689,774)	(838,667)	(999,238)	(160,571)		
Adjusted Operating Income	$9,900,381	$9,751,488	$9,590,917	($160,571)		
Operating Income Deficiency	$2,648,858	$3,075,936	$3,246,467	$170,532		
Gross Revenue Conversion Factor	1.636969	1.6370	1.6370	1.6370		Kissinger
Increase in Gross Revenue Requirement	$4,336,098	$5,035,210	$5,314,365	$279,155	Additional increase necessary to reflect the proper cash working capital and income tax levels.	

ATTACHMENT

"3"

ATTACHMENT 3

UNS GAS'

SUGGESTED AMENDMENTS

TO

RECOMMENDED OPINION AND ORDER

Amendment 1

CWIP

(1) Page 6, line 26 to Page 7, line 15 DELETE entire text

(2) Page 6, line 26 INSERT the following: Staff and RUCO make cogent arguments regarding why CWIP should not be allowed for many utilities. But in this case there is significant evidence that growth is causing substantial negative financial impacts to UNS Gas. In the long run, both ratepayers and shareholders benefit from financially healthy utilities. Accordingly, in this case, we will allow CWIP as a means of addressing the financial stress caused by growth and to put UNS Gas' financial condition on a firm footing. Furthermore, in light of the short-term nature of the construction projects included in the test year balance of CWIP, it is appropriate for UNS Gas to continue accruing AFUDC on all eligible construction projects with no offset required for the balance of CWIP included in rate base.

(3) MAKE ALL CONFORMING CHANGES

Amendment 2

Post Test Year Plant

(1) Page 8, lines 1 though 16 DELETE entire text

(2) Page 8, line 1 INSERT the following: Staff's concerns are valid in a generic sense. However, the evidence in this case shows that revenues from new customers do not come close to covering the costs associated with new plant to serve those customers. (Ex. A-28 at 10 and Attachment KCG-10) We have allowed post test year plant in many previous cases. UNS Gas' extraordinary growth and financial stress make it a good candidate for post test year plant, and we will accordingly grant UNS Gas' request to include post test your plant in rate base.

(3) MAKE ALL CONFORMING CHANGES

Amendment 3

Deduction of Advances related to CWIP

(1) Page 9, line 16 to Page 10, line 2 DELETE entire text

(2) Page 9, line 16 INSERT the following: As UNG Gas notes, the purpose of deducting advances is to ensure that the advance has no net impact on rate base. We would not permit advances to result in an increase to rate base, and by the same token, we agree that they should not result in a net reduction to rate base. We recently recognized in similar circumstances that deductions in such situations would cause rate base to fall rapidly, only to quickly bounce back as the related plant is placed in service. *Arizona-American Water Co.,* Decision No. 69914 (September 27, 2007) at 7. For the same reasons, we agree with UNS Gas and will not deduct advances that relate to test-year CWIP that is not yet in rate base.

(3) MAKE ALL CONFORMING CHANGES

Amendment 4

Geographic Information System (GIS)

(1) Page 10, line 24 to Page 11 line 8 DELETE entire text

(2) Page 10, line 24 INSERT the following: UNS Gas counters that rates should be based on the economic reality of costs, not bookkeeping mistakes. There is no dispute about the actual amount of the GIS costs. Because the GIS costs were mandated by this Commission and clearly result in increased safety and efficiency, we will recognize a regulatory asset for the GIS costs, to be amortized as proposed by UNS Gas.

(3) MAKE ALL CONFORMING CHANGES

Amendment 5

Return on Equity

(1) Page 44, line 16 to Page 45, line 11 DELETE entire text

(2) Page 44, line 16 INSERT the following: In the recent APS case, we weighed the competing arguments and approved an ROE that was significantly higher than the cost of equity recommended by the Staff in that case, which was based on the same witness and methods used in this case. In this case, we will follow a similar approach. UNS Gas has provided compelling evidence in support of a higher cost of equity relative to larger publicly-traded utilities, the vast majority of which pay common dividends and enjoy a much more moderate rate of growth in required plant investment. Accordingly, we will approve an ROE of 11%, which is only slightly higher than what was recently granted to APS.

(3) Page 45, line 8 INSERT revised chart reflecting option chosen

(4) MAKE ALL CONFORMING CHANGES

Amendment 6

Monthly Charge

(1) Page 56, line 2 to Page 57, line 9 DELETE

(2) Page 56, line 2 INSERT the following: RUCO, Staff and UNS Gas agree that the monthly charge should be revised to move closer to reflecting fixed costs. Moreover, we are concerned with the extent of the subsidy cold weather customers are providing to warm weather customers. We find that the monthly charge should be increased to better reflect fixed costs and to reduce the subsidy paid by cold weather customers. Accordingly we will adopt a monthly charge of $17.

(3) MAKE ALL CONFORMING CHANGES

Amendment 7

Rate Case Expense

(1) Page 22, line 6 to Page 22, line 18 DELETE entire text

(2) Page 22, line 6 INSERT the following: UNS Gas lacks the in-house rate and legal departments Southwest Gas relies on. Moreover, UNS Gas had to respond to twice as many data requests as Southwest Gas. We therefore agree with UNS Gas that its rate case expense cannot be directly compared to that of Southwest Gas. No party has suggested that UNS Gas has pursued frivolous issues or that their experts or lawyers cost more than normal. Accordingly, we will approve UNS Gas' proposed rate case expense.

(3) MAKE ALL CONFORMING CHANGES

Amendment 8

PEP

(1) Page 27, line 1 to Page 27, line 18 DELETE entire text

(2) Page 27, line 1 INSERT the following: As long as a utility's overall employee compensation costs are reasonable, we will allow recovery of the costs of the underlying compensation programs. As UNS Gas notes, incentive compensation is standard, both in the utility industry and in business corporations in general. Accordingly, we will allow recovery of UNS Gas' PEP costs.

(3) MAKE ALL CONFORMING CHANGES

Amendment 9

SERP

(1) Page 27, line 27 DELETE "In that case,"

(2) Page 27, line 28 to Page 29, line 3 DELETE entire text

(3) Page 27, line 28 INSERT the following: While we disallowed SERP costs in the most recent Southwest Gas rate case, we allowed them in the previous Southwest Gas rate case. As long as a utility's overall employee compensation costs are reasonable, we will allow recovery of the costs of the underlying compensation programs. Accordingly, we will allow recovery of UNS Gas' SERP costs.

(4) MAKE ALL CONFORMING CHANGES

Amendment 10

Officer's Incentive Compensation Program

(1) Page 29, line 3 INSERT new section as follows:

Officer's Incentive Compensation Program

Consistent with our treatment of the PEP, will not disallow UNS Gas' costs for its Officer's Incentive Compensation Program.

(2) MAKE ALL CONFORMING CHANGES

Amendment 11

Small Expenses

(1) Page 25, line 5 to Page 26 line 2 DELETE entire text

(2) Page 25, line 5 INSERT the following: We do not believe that it is reasonable to require a specific explanation for each of the 1,995 minor expenses challenged by RUCO, when RUCO only makes a general objection covering all of these numerous, disparate small expenses. RUCO did not rebut the explanation of these expenses by Mr. Gary Smith for UNS Gas. Accordingly, we will not disallow these costs.

(3) MAKE ALL CONFORMING CHANGES

Amendment 12

Fair Value

(1) Page 48, line 24 to Page 51 line 4 DELETE entire text

(2) Page 48, line 24 INSERT the following: We acknowledge that we must use fair value in setting rates. Staff's witness, Mr. Parcell, stated that using his approach, rates would remain the same no matter what fair value we find. (Tr. at 1024 to 1027). We do not see how that approach properly reflects fair value. Reluctantly, we will approve UNS Gas' proposal to apply the weighted average cost of capital to the fair value rate base. We will also hold UNS Gas to its commitment that the rates approved herein may not exceed the amount requested in its original rate application.

(3) MAKE ALL CONFORMING CHANGES

Amendment 13

CARES deferred balance

(1) Page 66, line 23 INSERT new paragraph, as follows:

Staff also recommends discontinuing further deferrals of CARES costs. We agree. UNG Gas has a deferred balance of $400,000 relating to CARES costs already incurred. We will allow this deferred balance to be recovered over three years.

(2) Make all conforming changes.

Amendment 14

Technical Corrections

(1) We direct that the final decision in this matter reflect the correction of all the calculation errors shown on Attachment 2 to UNS Gas' exceptions.

MAKE ALL CONFORMING CHANGES